



STATE OF WASHINGTON

OFFICE OF FINANCIAL MANAGEMENT

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December 17, 2002

The Honorable Gary Locke, Governor
Citizens of the State
Members of the Fifty-Seventh Legislature
State of Washington
Olympia, Washington 98504

In accordance with Chapter 43.88.027 of the Revised Code of Washington, the Office of Financial Management has prepared this Comprehensive Annual Financial Report (CAFR) of the state of Washington for the fiscal year that ended June 30, 2002. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the state. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the various funds and subsidiary accounts of the state. All disclosures necessary to enable the reader to gain an understanding of the state's financial activities have been included.

This is the first year the CAFR has been prepared in conformance with several new reporting standards that have significantly impacted report presentation. The objective of the new reporting model is to provide a clear picture of the government as a single, unified entity as well as providing traditional fund based financial statements. Both perspectives (government-wide and major fund) allow the reader to address relevant questions, broaden a basis for comparison (year to year or government to government) and enhance the state's accountability.

The report is presented in three sections: Introductory, Financial, and Statistical. The Introductory Section includes this transmittal letter. The Financial Section begins with the independent auditor's report and contains management's discussion and analysis (MD&A), government-wide financial statements, fund financial statements, notes to the financial statements, required supplementary information, combining financial statements, and schedules. This letter of transmittal is designed to compliment the MD&A, which presents a narrative introduction, overview and analysis of the financial statements. The Statistical Section includes selected financial, economic, and demographic data.

The state provides a wide range of services. These include education, social, health, transportation, environmental, law, public safety, resource and recreation development, public improvement, and general administrative services. The accompanying report includes all funds and subsidiary accounts of the primary government, the state of Washington as legally defined, as well as all of its component units. Component units are legally separate entities for which the primary government is financially accountable. The determination of "financial accountability" is based on criteria

established in Governmental Accounting Standards Board Statement No. 14. Note 1.A to the financial statements explains more fully which organizations are included in the reporting entity.

Profile of Washington State

The state of Washington was created by an enabling act of Congress in 1889. The state is located on the Pacific Coast in the northwestern corner of the continental United States. Washington comprises 68,139 square miles and currently has a population of 5.8 million. Washington is famous for its scenery of breathtaking beauty and sharp contrasts. On the west side of the state, high mountains rise above coastal waters. The forests of the Olympic Peninsula are among the rainiest places in the world. Washington's coastline has hundreds of bays and inlets that make excellent harbors. In the eastern part of the state, the flat semi-desert land stretches for long distances without a single tree.

Washington's location makes it a gateway for land, sea, and air travel to Alaska and the Pacific Rim countries. Ships from all parts of the world dock at Washington ports. The Boeing Company, a leading producer of commercial airliners and spacecraft, has plants in Auburn, Kent, Renton, Everett, and Spokane. Microsoft, a leader in the computer software industry, makes its home in Redmond. The Weyerhaeuser Company, a major producer of wood and related products, is headquartered in Federal Way. Costco Wholesale Corporation, headquartered in Issaquah, operates an international chain of membership warehouses.

East of the Cascade Mountain Range, farmers raise livestock and wheat on large ranches. Washington leads the nation in apple production. The state produces large amounts of lumber, pulp, paper, and other wood products. The mild moist climate in western Washington makes the region excellent for dairy farming and the production of flower bulbs.

Governmental Structure

As established in the State Constitution, the state consists of three branches of government: the Executive Branch, the Legislative Branch, and the Judicial Branch. The Executive Branch has nine elected officials as follows: the Governor, Lieutenant Governor, Secretary of State, State Treasurer, State Auditor, Attorney General, Superintendent of Public Instruction, Commissioner of Public Lands, and Insurance Commissioner. Forty agency heads are appointed by, and report to, the Governor. Eighty-eight agency heads report to a board appointed in whole or in part by the Governor. The Legislative Branch consists of two legislative bodies: the Senate consisting of 49 members, and the House of Representatives with 98 members. The Judicial Branch consists of the State Supreme Court that is the highest court in the state comprised of nine Justices. Every two years, three Justices are elected for six-year terms. A Chief Justice is chosen from among the most senior Justices.

Washington State's Economy and Revenue Outlook

Washington State's economy dipped into recession in Fiscal Year 2002. Wage and salary employment declined for the first time in 20 years. Personal income grew at an anemic rate of only 2.5 percent that fiscal year. Only a few fiscal years earlier, Washington's personal income was growing at rates that regularly exceeded 7 percent. The aerospace industry continued its

decline into Fiscal Year 2002 with an employment decline of 4.5 percent, but total manufacturing employment declined even more, 7.3 percent. This came on top of three consecutive years of employment decline in manufacturing. In Fiscal Year 2002, Washington's unemployment rate

reached 7 percent. As late as Fiscal Year 2000, the state's unemployment rate was below 5 percent. For several months during Fiscal Year 2002, Washington had the highest unemployment rate of all the states in the nation.

Washington's recession reflects the national recession and the decline in the stock market, as well as the impact on aerospace employment in Washington of financially weak air carriers and the substantial decline in air travel after the events of September 11th.

Washington's outlook for Fiscal Year 2003 is for continued recession followed by the beginnings of a recovery. Wage and salary employment in Washington is forecast to decline again in Fiscal Year 2003, but only by 0.7 percent. Real personal income growth is predicted to remain weak as the decline of stock option income continues after the stock market bubble burst. However, personal income is expected to rebound sooner than employment, growing by 3.8 percent in Fiscal Year 2003. General Fund-State revenues are forecast to decline slightly in the 2001-03 Biennium compared to the 1999-2001 Biennium due to the recession, but bounce back to a more normal rate of growth in the 2003-05 Biennium.

Economic Condition in Fiscal Year 2002

Washington's wage and salary employment declined at the rate of 2.0 percent in Fiscal Year 2002, a much steeper decline than the 0.8 percent fall in U.S. wage and salary employment growth. Washington's growth rate was much lower than its wage and salary employment growth rate of +1.2 percent in Fiscal Year 2001. The recession in Washington caused wage and salary employment to fall by more than 53,000 during Fiscal Year 2002.

Although the growth rate of wage and salary employment in Washington fell twice as fast as the national rate of growth during Fiscal Year 2002, personal income in Washington grew slightly faster than U.S. personal income, 2.5 percent in Washington compared to 2.1 percent for the U.S. Real per capita income growth was flat in Washington at 0.0 percent over the same period as compared to a slight dip of 0.2 percent for the nation as a whole. Some of the reasons for the slowdown in personal income growth include the national recession, the large decline in stock values, the impact of the stock market decline on high technology firms, and reductions in aerospace production and employment after September 11, 2001. Washington proved more vulnerable to recession pressures than other states due to the reliance of the state's economy on high technology firms and aerospace production.

Aerospace employment was a major factor in the year's slowdown in employment growth. After adding more than 15,000 employees in Fiscal Year 1998, employment in the aerospace industry fell by a total of 24,600 in Fiscal Years 1999 through 2001. Aerospace employment continued its decline in Fiscal Year 2002, falling by 3,900. Just as the aerospace employment decline began to moderate in Fiscal Year 2002, a host of other manufacturing industries went into decline. Manufacturing employment excluding aerospace in Washington declined by 21,700 jobs in Fiscal Year 2002, a reduction of 8.3 percent. Non-manufacturing employment growth fell by 1.2 percent, the first annual decline in twenty years.

Employment in durable manufacturing other than aerospace fell by 10.2 percent in Fiscal Year 2002 while employment in durable manufacturing nationally declined by 7.5 percent. Employment declined in every sector of durable manufacturing in Washington. The smallest decrease (2.1 percent) occurred in instruments. Employment in lumber and wood products manufacturing fell by 5.7 percent while employment in stone, clay, glass, and concrete products decreased by 6.7 percent in Fiscal Year 2002. All other durable manufacturing industries experienced declining

employment at rates greater than 7.5 percent during Fiscal Year 2002. The largest percentage declines occurred in the primary metals industry, down 25.9 percent (a decline of 2,800 jobs), and electronic and electrical equipment industry, down 18.4 percent (loss of 3,800 jobs). Durable manufacturing excluding aerospace declined by 15,800 jobs in Washington in Fiscal Year 2002.

Non-durable manufacturing employment in Washington decreased by 5.5 percent in Fiscal Year 2002 (loss of 5,900 jobs). Nationally, non-durable manufacturing employment declined by 4.4 percent. In Washington, all six non-durable manufacturing industries experienced employment losses in Fiscal Year 2002. The largest percentage losses of employment occurred in apparel, a 12.9 percent decline, and printing and publishing, a 7.4 percent loss. Employment in chemicals declined by 3 percent and employment in pulp and paper fell by 2.3 percent. Employment in food and kindred products decreased by 5.4 percent and experienced the largest absolute decline in number of jobs in non-durable manufacturing (loss of 2,200 jobs).

Non-manufacturing employment fell by 1.2 percent during Fiscal Year 2002, with transportation, communications and public utilities employment growth down 4.2 percent, construction employment falling 4.7 percent, and wholesale trade declining by 4.7 percent. Retail trade employment and services employment decreased by 1.9 and 2.3 percent respectively. Employment actually grew in the finance, insurance and real estate industry sector with an increase of 2.5 percent. Government employment also increased with state and local government employment growing by 4 percent and federal government civilian employment inching up by 0.2 percent in Fiscal Year 2002.

Economic Outlook

The economic forecast for Washington State for Fiscal Year 2003 reflects the impact of the recession at both the state and national levels. According to the November 2002 forecast by the state Economic and Revenue Forecast Council (ERFC), growth in Washington's wage and salary employment is predicted to fall by 0.7 percent in Fiscal Year 2003. Washington's employment performance is expected to be almost a full percentage point below national employment growth of 0.7 percent for Fiscal year 2003. However, the ERFC forecasts predict that wage and salary employment growth in Washington will catch up with U.S. growth by Fiscal Year 2005 with growth of 1.8 percent in Fiscal Year 2004 and 2.4 percent growth in Fiscal Year 2005. U.S. wage and salary employment are expected to increase by 2.3 percent in Fiscal Year 2004 and 2.2 percent in Fiscal Year 2005.

Personal income growth in Washington State is also expected to grow more slowly than the national average for Fiscal Year 2003. The ERFC economic forecast indicates that personal income in Washington will grow by 3.8 percent in Fiscal Year 2003, slower than the 4.5 percent growth expected for U.S. personal income. Washington's personal income growth will rebound in Fiscal Years 2004 and 2005 with growth of 4.4 percent and 6.1 percent, respectively. However, Washington's personal income growth will lag slightly behind U.S. personal income growth, which is predicted to be 5.5 percent in Fiscal Year 2004 and 6.4 percent in Fiscal Year 2005.

Manufacturing employment in Washington is projected to continue its decline into Fiscal Year 2003, due to the continuing effects of the national recession and the effects on the air travel industry following the events of September 11th. The ERFC suggests that aerospace employment will decline by another 12,200 workers in Fiscal Year 2003. This decline is expected to carry forward into Fiscal Year 2004 with a further reduction in aerospace employment of 7.1 percent, slowing to a decline of only 1.4 percent in Fiscal Year 2005. Other manufacturing sectors are expected to decline by about 7,000 in Fiscal Year 2003. However, growth is expected to return in

Fiscal Year 2004 with an increase in manufacturing employment excluding aerospace of 0.3 percent and increasing to 1.7 percent in Fiscal Year 2005.

In the non-manufacturing sectors, the strongest growth is predicted to occur in services. Services employment is forecast to return to growth with an increase of 0.9 percent in Fiscal Year 2003, but then rebound significantly with 4.1 percent growth in Fiscal Year 2004 and 3.6 percent growth in Fiscal Year 2005. Finance, insurance and real estate employment growth is expected to be another bright spot in the coming recovery. Employment growth in that sector is expected to grow by a modest 0.9 percent in Fiscal Year 2003, but grow more robustly at the rates of 2.8 percent and 3.6 percent in Fiscal Years 2004 and 2005, respectively. Federal government civilian employment is forecast to grow by 1.6 percent in Fiscal Year 2003, and then continue to grow by 1.3 percent and 0.7 percent in the next two fiscal years.

Retail trade employment is forecast to decline by 0.4 percent and wholesale trade employment by 0.6 percent in Fiscal Year 2003, reflecting the lingering effects of the recession. Retail trade employment should show improved growth of 1.8 percent in Fiscal Year 2004 and 0.8 percent growth in Fiscal Year 2005. Wholesale trade employment is forecast to rebound in a stronger way with employment growth of 3.5 percent in Fiscal Year 2004 and 3.7 percent in Fiscal Year 2005. Construction employment will remain weak during the next two years with a very small increase in employment of 0.2 percent in Fiscal Year 2003 and a small decline of 0.5 percent in Fiscal Year 2004. By Fiscal Year 2005, construction employment should regain some momentum and grow by 3.0 percent. Employment growth in transportation, communications and public utilities employment is predicted to decline by 1.1 percent in Fiscal Year 2003 but increase substantially afterward, by 4.5 percent in Fiscal Year 2004 and 4.6 percent in Fiscal Year 2005. State and local government employment is expected to begin feeling the impacts of serious budget cuts in Fiscal Year 2003 when employment is predicted to fall by 0.4 percent. State and local government employment is expected to fall by another 0.7 percent in Fiscal Year 2004, but return to very modest growth of 0.7 percent in Fiscal Year 2005 as revenues begin to recover with the economy.

General Fund-State Revenues

General Fund-State revenues for the 2001-03 Biennium are forecast to be \$21.1 billion, a decrease of 0.6 percent in nominal terms over the previous biennium. Without the effect of voter-approved initiatives, which lowered taxes and diverted revenues from the General Fund, revenues would be expected to grow by 1.8 percent in the 2001-03 Biennium.

General Fund-State revenues increased by 8.4 percent in the 1999-2001 Biennium compared to the previous biennium. The revenue growth rate for the 2001-03 Biennium is the slowest since the recession of 1981-83 and reflects the slowing state economy in response to the national recession and the financial and economic effects of the events of September 11th. The reduction in aerospace employment is a major contributor to the general slowing in the state economy, especially coming on the heels of almost three prior years of reductions. In addition, Washington

voters approved three initiatives to the people which reduced General Fund-State revenue in the 2001-03 Biennium: Initiative 728 diverted \$470 million in revenue to accounts supporting K-12 schools and education construction; also, Initiative 747 (property tax reduction) and Initiative 773 (funding for health care programs) reduced General Fund-State revenues by \$34.1 million in the 2001-03 Biennium.

Based on the November 2002 revenue forecast, Washington will have an estimated reserve of \$423.6 million by the end of the 2001-03 Biennium, down from \$1,061.6 million in the previous biennium.

Revenue growth is expected to rebound in the 2003-05 Biennium. General Fund-State collections are forecast to increase by 7.4 percent during that two-year period, generating revenue of \$22.7 billion.

Major Initiatives

Despite a difficult financial environment, Washington made significant progress in Fiscal Year 2002 to improve the state's public education system, make state government more efficient and responsive, cultivate economic development, and protect and preserve its natural resources.

Public Education

Governor Locke continued to pursue his first priority – improving Washington's public schools. The Governor and Legislature approved continued funding for a citizen initiative passed in 2000 to reduce class sizes, provide more individual teacher-attention to each student and retain quality teachers. In total, the initiative provided \$391 million for these purposes in the two-year budget biennium ending June 30, 2003. In accordance with the citizen initiative, the Governor and Legislature also supported cost-of-living pay increases to teachers for the second year in a row at a total cost for the biennium of \$333 million. The Governor and Legislature also tightened school district spending by reducing non-basic education grants and program reductions to save \$92 million.

Higher Education

Despite a difficult budget year, the Governor and Legislature took significant steps to improve the state's system of higher education. Gov. Gary Locke's two-year "Promise Scholarships" for financially strapped high school seniors at the top of their classes were written into law, giving the four-year-old program more stability and certainty. The Governor and Legislature also maintained enrollment growth targets despite reductions of 5 percent in state general fund appropriations to four year institutions, and 3 percent reductions to community colleges. All higher education institutions were granted limited authority to increase tuition in the next school year.

Economic Development

The Governor and Legislature took additional steps to improve Washington's economic climate and job opportunities. Funding was approved to expand enrollment for worker-retraining programs by 1,320 to 8,500 at community and technical colleges. Acting on recommendations from Governor Locke's Washington Competitiveness Council, the Legislature approved measures to improve equity and fairness in unemployment insurance taxation; to clarify taxation of investment income; to create a permit assistance center; to speed up business permitting; to authorize universities to finance research facilities with revenue bonds; and to further reform water law to make better use of this critical element of economic development.

Water and Salmon

Washington continued to make progress in Fiscal Year 2002 to better manage the state's water resources and protect threatened wild salmon populations. Legislation and additional funding helped to reduce the backlog of water rights change applications. Due to changes in the law, businesses, farmers and others channeled more existing water rights into new, more productive uses in new locations where water is most needed. This enhances economic development while preserving water in streams necessary to protect threatened wild salmon species. The state also continued to provide grants for both local salmon recovery projects and to develop local watershed plans to help guide the use of state water resources.

Cost Cutting and Quality Initiatives

The Legislature granted the Governor long-sought reform of civil service rules to create a more efficient state government personnel system. The legislation also permits collective bargaining and contracting out for more state services. To cope with a recession-driven budget shortfall, the Governor and Legislature eliminated several state programs to save \$59 million, and reduced the payroll by more than 1,400 full time staff positions. They also eliminated cost-of-living increases for state workers, saving \$50 million, and increased employee's share of health insurance costs to save an additional \$47 million.

State agencies completed five years of intensive review of state regulations, eliminating those that are unnecessary, and rewriting those that remain to make them easier for the public to understand. The regulatory improvement program has resulted in the elimination of more than 8,100 rules, the rewriting of more than 7,000 regulations in plain English, simplified regulatory processes, continued elimination of redundant and inefficient state boards and commissions, and faster adoption of rules to implement new laws.

Transportation Funding

Washington state voters in November 2002 rejected a \$7.8 billion proposal from the 2002 Legislature (Referendum 51) to finance statewide transportation improvements through increased gasoline and other transportation-related taxes and fees. Governor Locke and legislative leaders are studying possible options to finance much-needed expansion and repair of the state highway system. Action is possible during the 2003 legislative session. Voters in November also approved a citizen initiative (Initiative 776) that reduces state transportation-related funding by \$36.5 million and local transportation-related funding by \$185.2 million in the coming two-year budget period beginning July 1, 2003.

Welfare Reform

Despite an economic recession, Washington State continued to reduce welfare rolls and poverty among financially struggling families. In just five years, Washington's WorkFirst has put tens of thousands of people to work and cut the state's welfare caseloads nearly in half. Welfare grant savings are reinvested in services working families need most to stay employed and get ahead, such as child care, job training, work supports and tax credit education.

For the Future

Washington State faces a difficult test in balancing its recession-battered budget and providing services that are vital to economic development and the state's superior quality of life. Governor Locke will propose a spending plan that focuses on his priorities – education, economic development and public safety. He will propose a budget that delivers to citizens those services and programs that are clearly the most needed and justified.

Financial Management Information

Internal Controls

The state is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the state are protected from loss, theft, or misuse, and to ensure that adequate accounting data is compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. Internal accounting controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

Washington State continues to assess the adequacy of its internal control structure and make improvements where weaknesses are found. These actions will help assure that the state maintains public accountability for years to come.

Budgeting Controls

Budgetary control is maintained through legislative appropriations and the executive branch allotment process. The Governor is required to submit a biennial budget to the Legislature. The budget is legally required to be adopted through passage of appropriation bills by the Legislature with approval by the Governor. Appropriated funds are controlled by the executive branch through an allotment process. This expenditure plan details the appropriation into monthly estimates by program, source of funds, and object of expenditure. Nonappropriated governmental funds are also subject to allotment control by the executive branch. Additionally, the state maintains an encumbrance accounting system as one technique of accomplishing budgetary control. Encumbered amounts lapse at the end of the appropriation. However, capital encumbrances are generally reappropriated as part of the following biennial budget.

The state's budgetary policies and procedures, fund accounting structure, and basis of accounting are explained in detail in the notes to the financial statements and notes to the required supplementary information.

Retirement Plans

The state administers eleven defined benefit retirement plans and four defined contribution retirement plans covering eligible employees of the state and local governments. Note 11 to the financial statements presents plan descriptions, information on funding policies, and combining statements of plan net assets and changes in plan net assets.

Risk Management

The state has three insurance programs operated and accounted for as insurance businesses. Notes 1.L and 7 to the financial statements disclose the specific programs and claims liability changes during Fiscal Year 2002 for each insurance program.

Liabilities of the workers' compensation insurance activity amount to \$14.9 billion as of June 30, 2002. The liability includes \$7.2 billion for supplemental pension cost of living adjustments (COLA) that, by statute, are not to be fully funded. This COLA is funded on a pay-as-you-go basis, and the Department of Labor and Industries actuaries have indicated that future premium payments will be sufficient to pay these claims as they come due. The remaining \$7.7 billion in

claims liability is fully funded by long-term investments, net of obligations under securities lending agreements, held for payment of claims.

The risk management insurance activity liabilities amount to \$402.5 million as of June 30, 2002. This liability is currently funded by \$5.4 million in cash equivalents.

Health insurance activities have liabilities as of June 30, 2002, amounting to \$46.9 million that are fully funded with cash and investments, net of obligations under securities lending agreements.

Other Information

Independent Audit

State statutes require an annual audit by the Office of the State Auditor. The State Auditor is an independently elected public official. The state is also required to undergo an annual single audit in conformity with the provisions of the Single Audit Act of 1984 and U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

The State Auditor conducts the audit of all state agencies. In addition to meeting the requirements set forth in state statutes, the audit is also designed to meet the requirements of the federal Single Audit Act. The Auditor's report on the basic financial statements is included in the financial section of this report. The Auditor's report related to the single audit, including the schedule of federal financial assistance, findings and recommendations, and reports on internal control structure and compliance with applicable laws and regulations, will be published in a separate report. When completed, the report will be available on the Office of Financial Management website at: <http://www.ofm.wa.gov>.

Awards

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to Washington State for its Comprehensive Annual Financial Report for the fiscal year that ended June 30, 2001. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized Comprehensive Annual Financial Report, with contents conforming to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. Washington State has received a Certificate of Achievement for the last fifteen years. The Office of Financial Management considers this report to be in conformance with the Certificate of Achievement Program requirements, and will submit it to the GFOA.

Acknowledgment

The preparation of this report could not have been accomplished without the professionalism and dedication demonstrated by the financial and management personnel of each state agency and institution of higher education, and the Office of Financial Management.

This Comprehensive Annual Financial Report reflects the commitment of the Governor to the Legislature, the citizens of Washington State, and the financial community to maintain financial statements in conformance with the highest standards of financial accountability.

Sincerely,

A handwritten signature in black ink that reads "Marty Brown". The signature is written in a cursive, flowing style.

Marty Brown
Director